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SELECTED IMPLICATIONS OF THE CREATION OF THE BANKING UNION FOR THE ACCESSION OF POLAND INTO THE EUROZONE[1]

Summary
The last global financial crisis exposed a number of structural weaknesses of the eurozone which generated a great deal of additional costs as well as risks leading almost to its collapse. The creation of the Banking Union is hoped to strengthen the eurozone, however, it may not be enough, even when complemented with other reforms, to fully restore its effectiveness. Implementation of a common budget is necessary to enhance further integration of the euro area and to assure its financial stability. However, it seems that application of much less demanding tools of fiscal integration should be sufficient. A relatively small "insurance budget" would provide the definitive guarantee of bank deposits what would significantly reduce the risks for Poland when it joins the eurozone.

***Key words**: euro area, financial crisis, accession, financial stability, European integration*

Introduction

The present paper is a continuation of the author's research on the issues related to financial stability and focuses on implications that the

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[1] The views presented in the paper are the author's own and shouldn't be interpreted otherwise.

creation of the Banking Union may entail for the Polish accession into the eurozone. A large proportion of the content of the paper was already presented at an international conference on *Institutional Conditions of the Financial System as an Environment of the Real Economy Development,* held in Bielsko-Biała School of Finance and Law on 22 May 2015. The research methods used in the paper include critical analysis of literature, legal regulations and official publications but the author also draws upon his own professional experience acquired during his work for the European Systemic Risk Board (ESRB).

The recent global financial crisis clearly showed that the eurozone is not 'shock proof' and what is more, it can itself give rise to a chain of serious systemic risks. The regulations on the functioning of the European Central Bank (ECB) constitute a major structural weakness of the eurozone. The way of definition of the ECB's mandate arose particular doubts concerning admissibility of intervention on the market of debt issued by the eurozone countries (particularly in case of intervention regarding the debt of a single Member State). The intervention, however, turned out to be necessary in counteracting a situation in which cash flow problems of the eurozone countries could lead to their insolvency. Although these doubts were finally eradicated, the reaction came much too late and caused an increase in costs of the crisis threatening the stability of the eurozone as a whole[2].

Of course, the intervention of the Central Bank should not apply to the countries permanently insolvent. In some euro countries, however, where the lack of fiscal discipline did not seem to be a problem, excessive increase in the private debt occurred which resulted from incongruity of the level of interest rates, wrong perception of the risk (demand for credit) and active role of the banks (supply). The imbalances were also caused by the movements of capital between banks which were too powerful to collapse, enjoyed *implicit* government guarantees and support and were not appropriately supervised. It does not come as a surprise then, that no efficient remedial activities limiting the credit dynamics were undertaken at that time.

In the crisis conditions investors started to assess the risk of a given country not only as a scale of its public debt but also as a joint value of public and private liabilities. Such a perception of risk was caused by the

[2] The European Court of Justice adjudicated as late as on 16 June 2015, that buying out national government bonds by the European Central Bank in order to save the European currency is, as a rule, in accordance with the European law.

fact that in those days private debt started to fall on public finance. A surge in the risk perception led to a drastic constraint in funding for national governments which struggled with the banking crisis as it put a burden on their public finance. Only thanks to the intervention from the ECB and considerable support from international institutions, the countries with relatively disciplined public finance system managed to break away from the solvency crisis and return on international financial markets (Ireland, Portugal). These countries *de facto* never lost their solvency, thus it would have been better if the rescue had come in the form of an earlier solvency intervention because then the countries would not have lost access to the markets. Alas, such intervention had never come so funding from the market had to be replaced by loans offered by international institutions.

Another source of the eurozone problems was insufficient coordination of economic policy and, above all, lack of common fiscal policy which in the absence of reaction from monetary policy and exchange rate, could have alleviated effects of asymmetric shocks. Since the eurozone has not developed sufficient accommodative mechanisms and has not reached appropriate level of real convergence of its Member States, it may not be called the optimum currency area. What is more, a common currency area without a common country may be perceived as a rather unstable creation by the participants of financial markets. Thus, further integration and creation of institutions typical for a uniform state seems to be justified.

The Banking Union is an important step towards this integration because banks in the eurozone are treated as if they were functioning in one single country i.e. they are under uniform supervision and restructuring system and under a single *resolution*. In due course they are going to be under one system of deposit guarantees. The Banking Union is a good response to serious structural shortcomings of the monetary union but, unfortunately, it cannot eliminate problems resulting from the eurozone not being the optimum currency area. There still will be no common eurozone budget not only for fiscal policy purposes and for accommodation of asymmetric shocks but also to serve as the ‘ultimate guarantor’ (*backstop*) for the financial system. The European Stability Mechanism (ESM) is supposed to take this role, however, obviously, only to a limited extent. Although the ESM shall dispose of considerable resources, the value of these resources is determined in advance. For this

reason ESM will only be a substitute of a budget which, contrary to the fund, is based on regular income from taxation.

The structural repair of the eurozone seems to be a prerequisite for a successful accession of Poland into its structures. Only after considerable reforms may the eurozone offer substantial development chances without the risk of asymmetric shocks. Safe accession of new members requires not only financial stability within the eurozone but also further real convergence of new members' economies which will soften the risk of 'accession shock', which may be triggered by incongruity of interest rates and a possible credit boom. Real convergence is fostered by the following changes: strengthening of structural competitiveness, maintaining flexibility of the job market, reducing dualism on the job market, developing of the market of houses and flats for rent, increasing the efficiency of the product market and providing the so called 'fiscal space'.

This paper attempts at highlighting selected aspects of Polish accession into the eurozone in the context of new conditions which arose as the result of creation of the Banking Union. The author's considerations are aimed at assessing the extent to which the changes made so far will contribute to restoring and maintaining the eurozone stability, and financial stability in particular. The author does not discuss reforms, modernization challenges or the prospects of convergence of Polish economy as these issues were thoroughly described in a report of the National Bank of Poland titled: *Economic Challenges of Polish Integration with the Euro Zone* published in 2014. The paper consists of two fundamental parts: in the first the author analyses selected problems of the eurozone with special emphasis on structural weaknesses and the role of banks in generating systemic risks; this analysis helps to define the most important premises for the creation of the Banking Union. The second part concentrates on the implications of the Banking Union for Polish integration with the eurozone. Before it is possible to talk about a specific date of this integration, it is necessary to provide answers to a number of questions concerning the efficiency of solutions applied to safeguard financial stability of the eurozone which is one of the prerequisites for a safe accession.

1. Problems of the eurozone in the context of global financial crisis

The last recession generated unprecedentedly high costs. Especially heavy burden fell on public finances of some eurozone countries. Expenses paid to the rescue of endangered banks resulted in a drastic rise in public debt and in separation of these countries from financing from the markets. On average, the public sector of the EU was forced to recapitalize its banks with the amount equal to 3.4% of the European GDP (about 448 billion EUR[3]). The extent of recapitalization was different for different EU countries, some countries did not need any aid at all, others needed more than their national budgets could bear. Without the recapitalization, however, the banking system would inevitably collapse and the market economy system would be in serious jeopardy since the bank system is an engine for the economy supplying it with money and payment instruments. Contemporary money is of a deposit character and is created by credit actions initiated by commercial banks[4]. The collapse of the major players of the banking system would lead to the loss of deposits, thus to a situation in which money would cease to play its primary functions[5].

It is characteristic that the costs of bank recapitalization in the eurozone were covered from public finances of its Member States, whereas in the USA a large proportion of losses could be reduced thanks to increase in the market value of banks which received aid from the US and Fed government. Direct expenses on recapitalization of banks were not the only costs of the crisis. The real economy in the eurozone also suffered considerably. The EU GDP fell by more than 10% as compared to a long-term trend (Image 1). These calculations are, of course, just arbitrary because they depend on the choice of the trend parameter, however they offer a decent outlook on the scale of the incurred losses. The indirect cost of the crisis for the public sector i.e. decrement of the income from taxes translate into multiple of direct costs.

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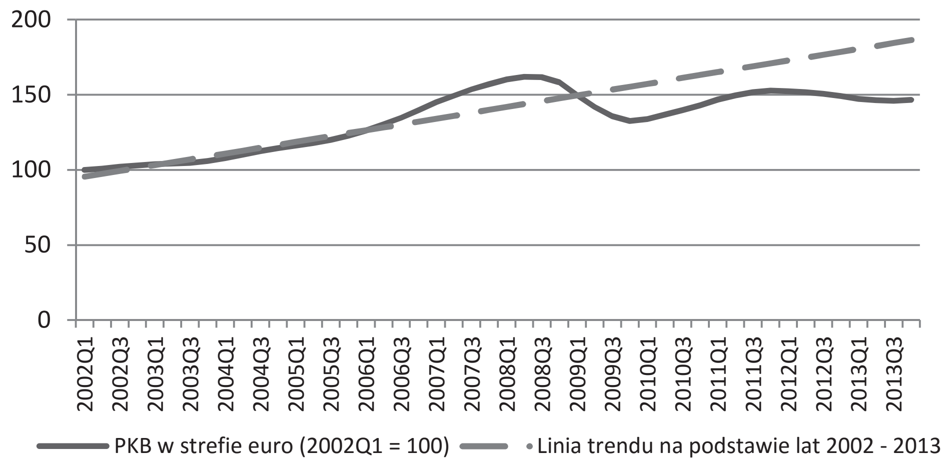
[3] State Aid Scoreboard 2014. Aid in the context of financial and economic crisis. European Commission (2014). http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html

[4] See: *Money creation in the modern economy*, Bank of England Quarterly Bulletin, Bank of England (2014).

[5] To be more specific, money is created by the banking system which consists of a central bank and commercial banks. It does not however rule out the statement that malfunction of commercial banks sector hinders the functioning of money, especially its transactional function.

Image 1. GDP in the eurozone (Q1 2002 = 100)



Source: Eurostat, author's own calculations

The financial crisis very quickly unearthed the structural problems of the eurozone which intensified the crisis even further and generated additional losses. The direct cause of the recession both in the USA and the EU was materialization of systemic risks related to exposure of banks onto the real estate market, too high leverage in bank activities (increased by the activities of unregulated institutions from the *shadow banking* sector) and mutual exposure in the financial system. The systemic risk in the eurozone was additionally magnified by the cross-border exposure of banks (mainly in the real estate sector)[6]. Moreover, the cross-border supervision over banks in the eurozone proved to be not tight enough.

A particularly accurate analysis of the causes of crisis in the EU can be found in *de Larosier Group* report[7]. In consequence, a number of regulatory initiatives was undertaken in order to counteract any possible future crisis. These initiatives included strengthening of individual institutions, protecting the financial system as a whole, reducing the costs of a next crisis, should it occur, and immunizing the public sector in the

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[6] See: N.T.L. Chan, *Excessive Leverage: Root Cause of Financial Crisis*, Hong Kong Monetary Authority, Speech at The Economic Summit 2012: Roadmap to Hong Kong Success, 9 December 2011.

[7] Report of the high-level group on financial supervision in the UE chaired by Jacques de Larosiere, The European Commission 2009. http://ec.europa.eu/finance/general-policy/docs/de_larosiere_report_en.pdf

event the risks materialize again. The undertakings embraced a number of spheres such as[8]:

- changes in prudential regulations for banks through raising the quality of capital, increasing the capital buffers and reducing the financial leverage;
- introduction of liquidity requirements for banks;
- identification of institutions of systemic meaning (SIFIs) and imposing additional capital requirements (buffers);
- reducing the moral hazard through restructuring regime and *resolution*; introduction of minimum requirement for own funds and eligible liabilities (MREL);
- reducing remuneration of bank executives and linking it to long-term performance;
- imposing regulations on rating agencies;
- regulating and increasing transparency on unregulated markets (OTC-over the counter), introducing a requirement to clear certain classes of derivatives by central counterparties (CCP);
- implementing reforms of bank structures;
- putting the shadow banking sector under some regulations;
- putting banks under capital requirement or exposure norms in government securities.

The proposed changes (implemented in the EU through regulation and directive CRD4/CRR[9]) aimed to strengthen the resistance of banks and provide tools of macroprudential character. Of key importance in strengthening the immunity of banks will probably be the loss absorbing

[8] See: P. Szpunar, *Polityka makroostrożnościowa – spojrzenie po kryzysie*; [in:] *Wyzwania regulacji rynków finansowych*, W. Rogowski (ed.); Oficyna Allerhanda, Kraków-Warsaw, pp. 17-18.

[9] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (Official Journal of the European Union L 176 of 27 June 2013 p. 338) (Capital Requirements Directive 4, CRD 4) and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (Official Journal of the European Union L 176 of 27 June 2013 p.1).

buffer i.e. *the minimum requirement for own funds and eligible liabilities* under Directive 2014/59/EU; MREL, which will consist of banks' capital and eligible liabilities to cover losses in the *bail-in* process within the *resolution*[10]. The MREL requirement will be defined in Pillar 2 procedure, individually for each bank, a solution which seems reasonable taking into account various risk profiles of particular banks.

Key regulatory initiatives were accompanied by the newly created supervisory body called *Macroprudential Authority*[11]. Contrary to macroprudential supervision which would concentrate on stability of individual institutions, the new authority focuses on identification, analysis and active reduction of systemic risks which threaten the stability of financial system as a whole (or its important constituents)[12]. The most important tasks of macroprudential policy may be defined as follows[13]:

- analysis of the financial system as a whole, its important constituents and its links with the real economy in order to monitor, assess and control systemic risks. It has already been done before, central banks in many countries published reports on stability of the financial systems (the Polish National Bank (NBP) has been publishing such reports since 2001);
- early identification of threats (sources of shocks) for the stability of the financial system;
- assessment of resistance of the financial system to potential shocks;
- issuance of warnings and recommendations of appropriate steps towards eliminating occurrences increasing systemic risks, particularly outside the financial system;

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[10] J. C. Pardo, V. Santillana, *The European MREL: main characteristics and TLAC similarities and differences.* BBVA, 2014.

[11] First references to *macroprudential policy* can be found in professional literature of the 1970s. See: P. Clement, *The term 'macroprudential': origins and evolution*, BIS Quarterly Review, March 2010, http://www.bis.org/publ/qtrpdf/r_qt1003h.pdf. More on this topic in: C.A.E. Goodhart, *The Macro-Prudential Authority: Powers, Scope and Accountability*, OECD Journal: Financial Market Trends, Volume 2011 – Issue 2, OECD 2011, p. 5. http://www.oecd.org/finance/financial-markets/48979021.pdf

[12] More on the differences between micro and macroprudential supervision: C. Borio, *Implementing a Macroprudential Framework: Blending Boldness and Realism*, Bank for International Settlements, 2010, p. 18.

[13] See: Szpunar P., *Rola polityki makroostrożnościowej w zapobieganiu kryzysom finansowym*, Materiały i Studia, No 278, NBP, 2012.

- application of specific prudential instruments to response to the risks identified in the financial system, counteracting or, at least, reducing the accumulation of risks in the system – such measures were missing in the financial system before the crisis, there was no institution which would dispose of a mandate to undertake any remedial steps;
- application of prudential instruments to build shock resistant buffers for the financial system and for the economy as a whole – this step had also not been taken before the crisis[14];
- coordination of preventive activities within the group of institutions in the financial security network.

Regardless of assessment of previous, before-crisis regulatory solutions, the creation of macroprudential supervision should be treated as a top priority. Firstly, it fills a niche in the existing macroeconomic policy paradigm, secondly, even the best regulations cannot replace macroprudential policy because the financial system is a subject to constant changes and innovations. As a rule, the supervisors and law makers react to such changes with a considerable delay and it happens every so often that this delay is of critical importance for the financial stability. In other words, effective macroprudential policy is to some extent more important than regulations of the financial system because its task is to analyze the consequences of regulations and to propose regulatory changes necessary for reducing the systemic risk[15].

The institutional solutions introduced in the EU in accordance with the recommendations from *de Larossiere report* i.e.: the creation of the European Systemic Risk Board (ESRB) which replaced the former supervisory committees, establishment of the three European supervisory authorities[16] and implementation of the CRR/CRD4 package, were not sufficient for the eurozone as their only aim was to provide financial stability and counteract future crises. The eurozone, however, needed

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[14] Of course this wasn't always the rule. In Poland, for example, some of the Banking Supervision Authority (later the Polish Financial Supervision Authority) recommendations may be understood as macroprudential activities, for instance *Recommendation S* of 2006 (*Recommendation S on good practices related to mortgage-secured credit exposures*, the Banking Supervision Authority, Warsaw, 2006).

[15] C. Borio, *Towards a macroprudential framework for financial supervision and regulation?,* BIS Working Paper No 128, Bank for International Settlements 2003, and A. Crockett, *Marrying the micro- and macro-prudential dimensions of financial stability*, Bank for International Settlements, 2000.

[16] ESAs.

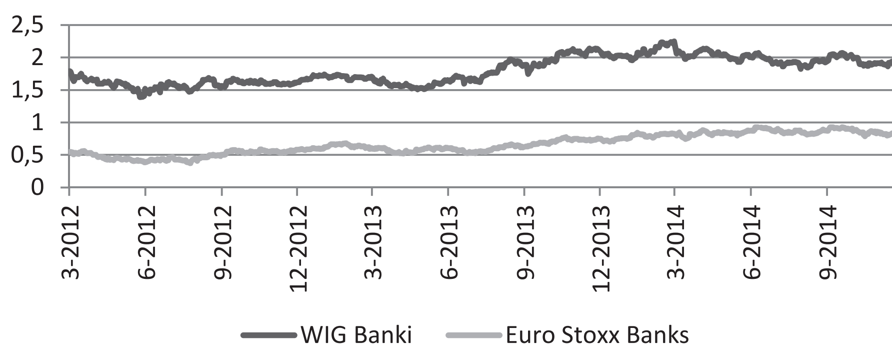
hands-on crisis management to eliminate at least a part of structural weaknesses which escalated the recession. This could have been achieved by means of the negative feedback mechanism of worsening situation of banks and public finances. The global financial crisis revealed that the construction of the eurozone constitute, in itself, a serious source of systemic risks. A major structural weakness of the eurozone is the ECB whose regulations so as to its aim and functioning impeded the intervention on the market of debt issued by the Member States (on the debt market of a single Member State in particular). Although the intervention on the primary market of securities is forbidden by the Treaty, even intervention on secondary market of sovereign debt arose controversies and disputes of legal nature which put off the decision making process. As the result, being part of the eurozone *de facto* increased sensitivity of its members towards liquidity crisis. In a unitary country, the national central bank may always intervene on the long end of the yield curve. What is important, however, is that such interventions should only be undertaken in real emergency situations.

In view of the doubts concerning possible intervention from the Central Bank, the liquidity problems of countries may easily transform into solvency problems. When in 2011, on the wave of aversion towards the eurozone risks, the yield of bonds issued by the so called peripheral countries started to go up, there was no remedy whatsoever to reverse this tendency (the financial markets liked to repeat the saying 'trend is your friend'). In such a situation the ECB had to take a stand and became *the lender of last resort*. It was then when two remedial programmes *outright monetary operations* (OMT) and *long-term refinancing operations* (LTRO) were announced. The intervention turned out to be highly efficient. However, it was obvious right from the start that this is just an *ad hoc* solution which cannot be used without limits as it generates a temptation of abuse. The alleged guarantee of the Central Bank intervention triggers further loosening of fiscal discipline and reinforces one of the causes of the recent crisis – insufficient fiscal discipline. It also turned out that ECB instead of being the *last resort* in the fight against crisis became the most important, *first instance.* It led to a general conviction that the eurozone as a common currency area without a common country is a creation unstable by nature. It is therefore propagated that either the eurozone creates state-like institutions or it

remains unstable[17]. It means that beside monetary and financial policy it is necessary to coordinate other policies as well, and fiscal policy in particular. It is however difficult to imagine functioning of state-like institutions and fiscal union without a political union. In present situation of the eurozone, however, such undertaking seems to be impossible to carry through.

It was so much easier to conduct a common policy in case of banks as this sector was already well-integrated. In the light of immense costs of the last crisis, the pursuit of Euro countries for defense of independence of their supervisory policies, although quite understandable, was considerably suppressed. Establishment of the Banking Union was not only a necessary but also the only still feasible step towards further integration of the eurozone as it restored coherence to the eurozone and additionally offered serious reputational advantages as it put an end to a hazardous link between the situation of banks and public finances in the eurozone countries. Thanks to the Banking Union banks regained their credibility what proved helpful in times of crisis. Despite the rise in past and current financial encumbrance for banks (costs of reporting, SRM contributions and national *resolution* funds), the market value of European banks went up the moment the establishment of the Banking Union was announced (Image 4)[18]:

Image 4. Market value of European banks



Source: Financial Stability Report, the Polish National Bank (NBP), January 2015.

[17] P. De Grauwe, *Design Failures in the Eurozone: Can they be fixed?,* LEQS Paper No. 57/2013.

[18] On 12 September 2012 the European Commission published a draft resolution granting the European Central Bank competences within macroprudential supervision over banks in the eurozone.

The Banking Union was an important step towards integration as banks in the eurozone function as if they were operating in a single country, they are subject to a uniform supervision and restructuring system as well as resolution, what is more, in the future they are also to be covered by a uniform deposit-guarantee scheme.

The Banking Union solves a number of problems with coordination within colleges of supervisors and problems related to the lack of tight cross-border control. The situation of banks too big to collapse is also better now thanks to the existence of the Banking Union as their financial condition may, at least to some extent, relate to financial capacity of the eurozone as a whole instead to its individual members. The Banking Union also reduces forbearance of national supervision systems, which used to result in low quality of credit portfolio and undervaluation of banks' capital needs[19]. However, there still will be no common eurozone budget which could become the ultimate guarantor (*backstop*) for the financial system. The European Stability Mechanism (ESM) is supposed to take this role, however, obviously, only to a limited extent. Although the ESM shall dispose of considerable resources, the value of these resources is determined in advance. For this reason ESM will only be a substitute of the budget which, contrary to the fund, is based on regular income from taxation.

One of the primary aims of the Banking Union is institutional strengthening and protection of the ECB's independence with respect to the monetary policy. The ECB, which *de facto* functions in the territorially extended 'Bundesbank mandate' i.e. highly independent central bank that focuses mainly on stability of prices, must have a choice between financial and monetary stability with clear priority given to the latter. The ECB during the intervention of 2011 did not have to confront its anti-crisis activities with its price stability mandate. Despite this, however, this situation not only was uncomfortable but also dangerous for the autonomy of the ECB's monetary policy as it evoked a temptation for abuse. Only thanks to the ECB's intervention in times of crisis, could the stability of the eurozone be maintained. Even the potentially insolvent banks could retain their liquidity and generate extraordinary profits what strengthened their equity. Within the Long Term Refinancing Operation (LTRO)-three operations of joint value of about 1 bln EUR, the banks could borrow from the ECB resources for up to 36 months at a fixed cost

[19] See: Angeloni I., *Building the European Banking Union in Times of Crisis*, 2013.

of 1% per annum, with government bonds bought with the borrowed money used as collateral. This bonds, as a rule, generated a stable income in EUR currency of a couple per cent per annum. Purchase of government bonds with money borrowed from the ECB, allowed banks to generate considerable profits completely risk free. This arbitration was a double win as it created enormous demand for bonds, putting an end to sudden decrease in their prices and enabled banks, weakened by the ongoing crisis, to underpin their sagging capitals.

Such a venture however, raised serious doubts because traditionally it was the government that had been the guarantor of bank solvency and for the first time this role was taken over by the Central Bank. It is obvious that Central Bank has always had the right to intervene on the yield curve, its long end included. On the other hand, only the fiscal authorities should have the mandate to undertake activities which implicate redistribution effects of this kind. Nevertheless, governments of some countries lost, due to the crisis, the ability to finance themselves on the market and as the result were threatened with loss of solvency. The ECB really did not have a choice but to offer its support to these governments[20] and rescue the eurozone from collapse. Not only was the ECB responsible for monetary stability and, indirectly, for financial stability (which is a prerequisite for monetary stability) but also at that time there was no other body or institution capable of saving the eurozone. Unfortunately, the ECB intervention lessened the pressure on national governments and supervisory systems to monitor public finance and to rescue or shut down inefficacious banks. It can be thus argued that assumption by the ECB of the control over banks strengthened its position and protected its independence as insolvent banks will no longer be recapitalized through monetary operations of the Central Bank. Should the ECB discover shortages of capital in one of the banks it supervises, this bank will have to receive recapitalization either from its owners, government or ESM direct recapitalization instrument; alternatively the bank may be restructured or liquidated in an orderly manner. Efficient supervisor must of course dispose of the right to shut down any bank endangered with bankruptcy, hence there is a need for efficient second pillar of the Banking Union which will assure orderly liquidation process (resolution, SRM). The Banking Union and its three

[20] See: M. Hellwig, *Yes Virginia, There is a European Banking Union! But It May Not Make Your Wishes Come True*, Preprints of the Max Planck Institute for Research on Collective Goods, Bonn 2014/12.

pillars are, at the same time, an indispensable complement to the monetary union.

The Banking Union eliminates yet a part of fundamental structural weaknesses of the eurozone. The monetary union is constituted by the common Central Bank conducting joint monetary and exchange rate policy and sharing the profits (seigniorage) according to a predetermined manner. This helps to develop a common monetary market which becomes a foundation for a uniform currency. At the theoretical grounds of the monetary market lies the theory of Optimum Currency Area[21]. The OCA concept, which originated in disputes over optimum system of exchange rates, has evolved with time to such a volume that the present paper may not even summarize its most important threads[22]. Its most fundamental idea however, is that the optimum currency area is a place where introduction of a single currency boosts the prosperity of the region. OCA may also be defined as an area where the existence of a single currency does not hinder the execution of economic policy (internal balance i.e. stable prices and full employment; external i.e. balance of payments). This definition leads to the assumption that OCA must be resistant to asymmetric shocks (an economic or political occurrences that change macroeconomic conditions by affecting demand or supply in countries that share a common currency) and the classic definition of OCA is precisely based on the concept of minimizing the impact of asymmetric shocks[23]. Reduction of this impact can be achieved by mobility of production factors inside the common currency area and well-coordinated monetary and fiscal policy[24]. In view of what was said above, it is clear that the eurozone of the future is far from what can be called the optimum currency area[25].

The creation of the eurozone, a flagship project of the European Union, was preceded by a long-period of preparations fuelled by the

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[21] Hereinafter referred to as OCA.

[22] Polish literature on the subject see: J. Borowski, *Polska i UGW: optymalny obszar walutowy?*, Materiały i Studia, No 115, NBP, Warsaw, 2000; G. Tchorek, *Teoretyczne podstawy integracji walutowej* [in:] *Mechanizmy funkcjonowania strefy euro*, P. Kowalewski, G. Tchorek, J. Górski (ed.), Warsaw 2011.

[23] R. Mundell, *A Theory of Optimum Currency Areas*, 1961.

[24] A. R. Ghosh, H. C. Wolf, *How Many Monies? A Genetic Approach to Finding Optimum Currency Areas*, NBER Working Papers, No 4805, pp. 5 – 11, 1994.

[25] D. Gross, N. Thygesen, *European Monetary Integration: From the European Monetary System to European Monetary Union*, New York, 1992; P. De Grauwe, *Economics of Monetary Union*, Oxford University Press, 2000.

dedication to integrate and unify Europe. Common currency was supposed to lay the foundations for further development of institutional integration and counteract political conflicts which were inflicted by rival devaluations. Special emphasis was put on the benefits coming from the monetary union such as: considerable reduction in perception of macroeconomic risk, better availability and lower costs of capital, revitalization of trade exchange with the eurozone through elimination of the foreign exchange risk, withdrawal of some transactional costs as well as better comparability of prices and increased competitiveness. At the same time attempts at theoretical justification of introducing a common currency in the area which was far from being OCA were undertaken. The OCA concept assumes exogeneity of criteria, however, J. A. Frankel and A. K. Rose allowed the criteria to be endogenic, because as the result of introduction of euro currency the real convergence was expected to accelerate. Moreover, the appearance of demand-related asymmetric shocks was hoped to be accommodated, to a certain extent, by the increase in trade integration[26].

In reality, the creation of the eurozone did not bring the desired positive effects. On the contrary, the monetary union accelerated growth of economic imbalances and intensified the systemic risks. The eurozone is, above all, a political project so a number of compromise solutions had to be adopted. The first compromise was 'extending' the rules of functioning of the German Central Federal Bank (the Bundesbank mandate) upon the whole eurozone, otherwise Germany would probably never agree to give up on their own currency. However, the way Bundesbank operates is based on the model of German economy which is open, highly competitive, export-oriented and sensitive towards internal demand. That is why a large proportion of benefits coming from integration as advocated by it supporters, soon turned out to be a source of serious problems.

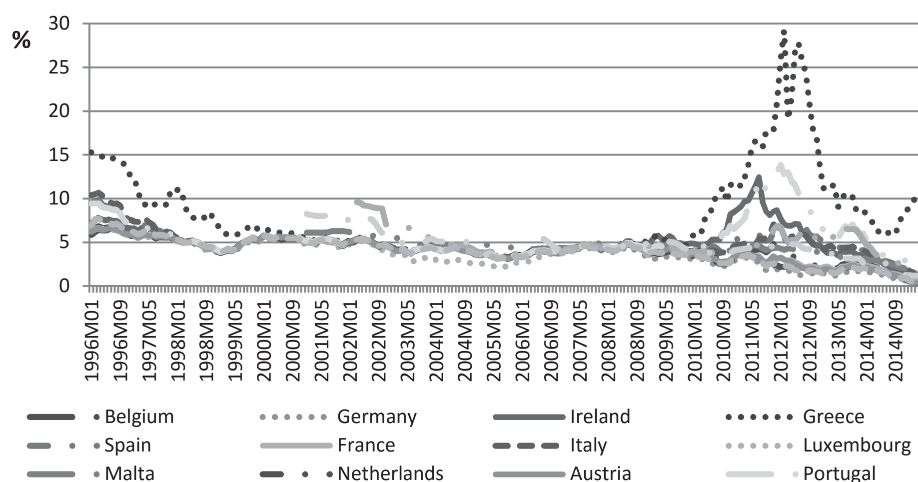
In the first few years of its existence the eurozone seemed to be functioning smoothly until the global crisis revealed all the soft spots of the system such as weaknesses of the supervisory policy (lack of coordination, leniency, absence of macroprudential policy) and ill matching of the restrictiveness of monetary policy of the ECB to the macroeconomic situation of non convergent economies of the eurozone.

[26] J. Frankel, A. Rose, *The endogeneity of the optimum currency area criteria*, NBER Working Paper, Cambridge 1996.

This led to accumulation of systemic risks which, when materialized, fortified the negative effects of the crisis. The eurozone countries, burdened by the crisis with varying degrees, coped with it as well as they potentially could, however collective assistance could only arrive after some of the countries lost the access to market financing. Another ill of the eurozone was the lack of fiscal discipline clearly visible in inefficient community control mechanisms as regards expenditure, deficit, fiscal independence, weak reporting system, lack of central budget and no redistribution of a reasonable part of the eurozone income.

The introduction of euro as a single currency weakened the perception of credit risk which was favoured by convergence of credit costs caused by the activities of the ECB to secure its monetary operations in which it accepted, on similar basis, bonds issued by all eurozone members. It contributed to a large extent to convergence of profitability of these bonds despite completely different profiles of credit risks and ratings of issuers (Image 5). Only few experts (for example Willem H. Buiter) paid attention to the above mentioned risk.

Image 5. Profitability of 10 year bonds of selected euro countries (1996 – 2015).



Source: Eurostat

The illusion of low credit risk, prospects of *prosperity* together with low interest rates led to excessive indebtedness of public sector in a number of Member States and to aggregation of private debt what, in turn, led to unstable booms on real-estate markets. Simultaneously, contrary to original intentions, real divergence started to be felt in the

form of increase in competitive differences in the soft budget constraint environment, high transfers, too low interest rates in some peripheral countries and lack of payment discipline. The banks which were too big, badly supervised and undercapitalized could benefit from transfers of funds between non convergent regions. Absence of macroprudential supervision in conditions of free flow capital without exchange rate stabilizer as well as wide-scale cross-border activity opened doors for banks to finance unstable credit booms. The banks which were too big to go bankrupt contributed to the negative feedback between their own condition and the condition of public finance of some euro countries as soon as the risk they (the big banks) generated materialized.

This situation was not a coincidence. Banks, to a large extent, contributed to accumulation of systemic risks due to their certain privileges. The ‘single passport’ allowed for easy and cheap cross-border exposures. Common monetary market had been functioning smoothly allowing for cheap financing of credit action strengthening the illusion that the risk did not exist. Generous deposit guarantees reduced the costs of financing for banks, political support (‘flagships of the economy’) additionally cut these costs through offering *implicit* guarantees. Active capital flow operations conducted by cross-border banks weakened the macroprudential supervision which is, by nature, focused on banks within one single jurisdiction and delayed the moment when the systemic risk, which this banks generated, could be noticed. Everything had seemed all right as banks could finance themselves on the euro market. This illusion of a common currency was probably the most costly and created a situation in which the global financial crisis hit the eurozone with double intensity.

Since commercial banks provide the economy with public commodity i.e. money and maintain its circulation on the market, it was necessary to get the banks rolling. In practice it meant offering them *implicit* public guarantees which turned out to be very expensive. That is why, it became obvious that an alternative system was necessary, a system which would protect the economy against the effects of collapse of systemically important banks. The system of restructuring and orderly liquidation called *resolution,* which respects the deposit guarantees up to 100,000 EUR, is hoped to provide financial stability thanks to which money can perform its basic transactional, measure of value and store of value functions, even in crisis situation. However, in the European Union it was decided to rely only on such solutions which burden the private

sector only. It is a reaction fully understandable after the last financial crisis whose costs fell predominantly on the tax payers. This assumption may, all the same, limit the efficiency of the new system as financing of the *resolution* process may prove to be very difficult.

2. Prospects of Polish accession to the Monetary and Banking Union – key issues for the Polish economy and financial system

So far the National Bank of Poland has published two reports concerning costs and benefits of Poland's full participation in the monetary union (in 2004 and 2009[27]). Both reports embraced a wide spectrum of economic consequences of introduction of euro currency in Poland and the forecasts assured that in the long-term benefits related to prospective economic growth should outweigh any negative effects. The key benefit was backing of investments through permanent reduction of interest rates. At the same time it was argued that chances for a credit boom were not very big and that costs of loss of an important stabilizer in the form of a liquid exchange rate and independent monetary policy should be considerably reduced. The 2009 report was supplemented by an annex which was the first reaction to the global financial crisis. The annex accentuated possible threats the crisis could bring, however the nature of danger was not yet recognized. From today's perspective it can be claimed that permanent lowering of interest rates and common monetary market contributed to unprecedented accumulation of imbalances and systemic risks. Low interest rate illusion was reinforced by the ECB policy which accepted on the same basis bonds of all eurozone Member States. This added to wrong perception (undervaluation) of risks in some countries. The issuance of public debt in euro currency was, however, different in character than issuance of public debt in national currency before the creation of the eurozone. There was one fundamental change: none of the euro countries had 'its own' central bank which would be authorized to intervene on the debt market in the event of loss of liquidity.

At the time following the Polish accession into the EU, Polish economy was growing at a good pace reaching the highest compound

[27] *A Report on the Costs and Benefits of Poland's Adoption of the Euro*, National Bank of Poland (NBP), Warsaw 2004; *Report on Full Membership of the Republic of Poland in the Third Stage of the Economic and Monetary Union*, National Bank of Poland (NBP) Warsaw 2009.

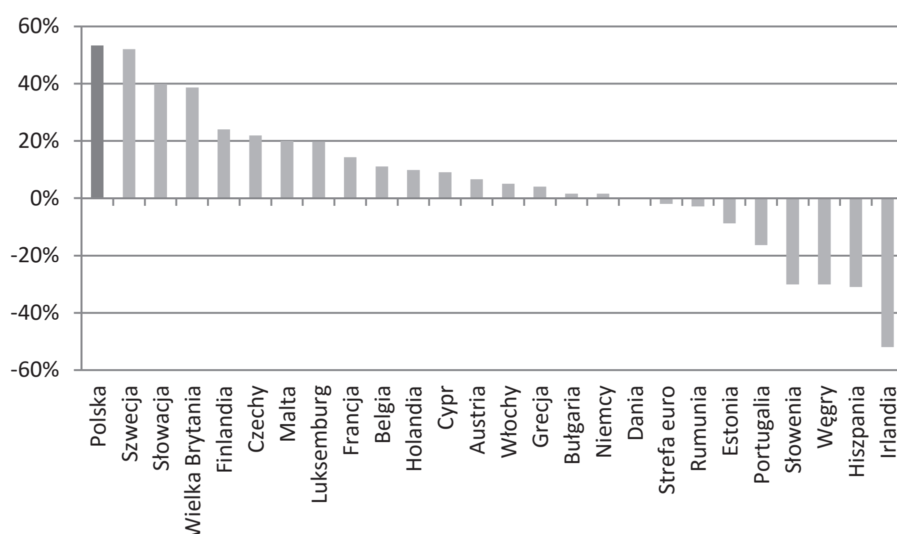
rate of economic growth (Image 6). Such a spectacular success was owed to at least two groups of factors. Firstly, the structure of Polish economy helped to maintain a stable growth: its relatively low openness weakened the negative demand-related shock from the eurozone and high diversification of production helped to secure the sales markets. Poorly developed sector of financial services, absence of complex products and strategies and low debt of the economy protected Polish banks from shocks despite a considerable large portfolio of foreign currency credits. Paradoxically, some characteristics of Polish economy which could tell of its low level of advancement, in times of crisis turned out to be a protective shield. Secondly, the economic policy conducted at that time in Poland worked counter-cyclically; the fiscal impulse being a consequence of reduction of contributions from salaries and tax cuts fuelled private consumption in the conditions of negative demand-related shock in the eurozone. It was hardly an intended action of Polish authorities as the decision had been taken long before the crisis even started.

Strong growth in public investment was, on the other hand, carefully planned. In 2009 public investments to a large extent replaced shrinking private ventures. Internal demand was also boosted by the monetary policy. Reduction of interest rates from 6% to 3,5%, was backed by the so called 'Confidence Package' introduced by the National Bank of Poland in October 2008. Within the whole set of activities of the 'Package' NBP started to open market operations feeding banks with liquidity for longer periods of time (mainly 3 months), despite considerable structural excess of liquidity in the banking system. In the arbitration conditions the rates of monetary market went down following the reductions in reference rates of the NBP. It was of fundamental significance for loosening of monetary conditions as WIBOR 3M rate is essential for the transmission of monetary policy because costs of majority of credits and deposits are indexed in accordance to this rate. Moreover, NBP started to feed banks with foreign currencies within *swap* transaction, including CHF (upon agreement with the National Bank of Switzerland). It provided banks with foreign currency liquidity in very difficult market conditions. Although the scale of *swap* operations was not relevant (in 2009 it amounted to 1billion PLN)[28], they provided

[28] See: 2009 Annual Report – *Liquidity of the Banking Sector. Instruments of Monetary Policy*, National Bank of Poland.

a vital kind of insurance for banks considerably reducing the risks of their activity. More important than reduction in credit costs was, however, accelerated depreciation of PLN. In the conditions of negative demand-related shock from the eurozone, the accelerated depreciation boosted competitive advantage of Polish companies and enhanced their chances for their continuity. In 2009 the volume of Polish export expressed in EUR fell by about 17%, but as expressed in PLN it went up slightly, what allowed exporters to keep employment at a stable level and boosted private consumption. The International Monetary Fund estimated that depreciation of PLN was the second most important factor, next to the fiscal impulse, which helped to protect Poland against recession. Needless to say, avoiding recession was only possible thanks to the fact that Poland was outside the euro area (and, as the result, was not burdened with the costs of helping Greece out). High rate of growth substantially eliminated differences in income *per capita*, putting Poland on a solid path towards real convergence.

Image 6. Accumulated rate of growth in EU countries for the period 2008 - 2014

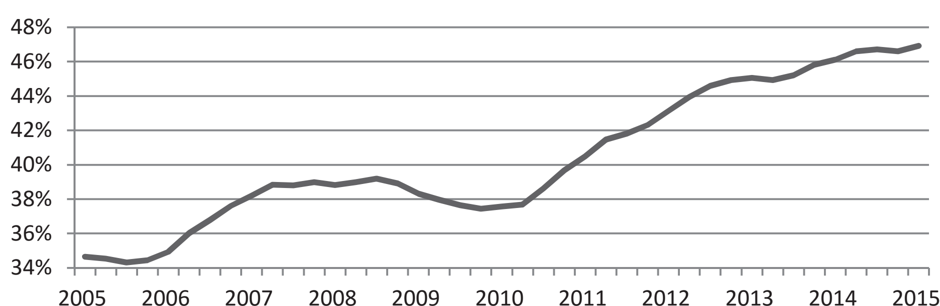


Source: Eurostat, author's own calculations

What is even more important, rapid growth of Polish economy was sustainable and lasting as well as free of any kind of dangerous imbalances. This growth was one of the biggest in the EU and was accompanied by the creation of manufacturing potential and

infrastructure with much funding coming from the EU budget. The situation on the job market improved, the unemployment was reduced and the activity rate also went up. However, the value of activity rate is still relatively low and for that reason its further growth may become a kind of a buffer reducing the impact of constantly worsening demographic situation on the pace of potential growth. Migration of Polish labourers proved to be a strong negative impulse for potential growth but the job market managed to maintain its flexibility and the prices could rise moderately. The inflow of investments and increase in production potential with relatively low wage dynamics resulted in very slow increases in unit labour costs and fostered competitiveness. Within just seven years export of goods and services from Poland doubled (as expressed in EUR) also the share of export in GDP increased (Image 7).

Image 7. Export of goods and services from Poland, ratio to GDP



Source: Central Statistical Office, author's own calculations

The odds are that Poland which traditionally imported capital and had permanent deficit on current account, may become exporter of capital as there is recorded stable surplus in balance of payments. According to IMF, the current account balance is near to the level coherent with the foundations of the economy[29]. In this situation it cannot be denied that Polish accession into the EU brought a double benefit: first it opened doors to the inflow of European funding, forced introduction of higher standards, increased the political significance on international arenas and enhanced the perception of stability; secondly, Poland being outside the eurozone not only escaped crisis but also, in some ways, capitalized on it.

[29] See: Pilot External Sector Report, IMF, July, 2014.

Before the crisis the NBP's reports mentioned above presented only model simulations which indicated that the adoption of EUR as a currency would lead to higher GDP due to:

- fall in interest rates,
- reduction in foreign exchange risks,
- elimination of transaction costs and increase of macroeconomic stability.

It was thought the adoption of EURO would accelerate economic growth and that the level of affluence of Polish society would increase. In November 2014 another NBP report was published[30]. This time, however, it not only focused on chances but also on threats related to the entry into the eurozone. Both costs and benefits of the entry turned out to be conditional. Crisis experiences showed that EURO does not always translate into fast economic growth, quite the opposite, economic growth is faster and more possible outside the euro area. Adoption of EURO may lead to building up of macroeconomic imbalances, increase in the amplitude of cyclical changes and fall in macroeconomic stability. The bottom line of this report may be summarized as follows: adoption of EURO as a currency is 'as much' and 'as little' as a chance for speeding up economic growth and increasing the level of social affluence.

Poland must take two strategic decisions: firstly, choose the right moment of EURO adoption and secondly, decide whether or not enter the Banking Union beforehand. The latter option would be, however, rather detrimental[31]. As far as the date of Poland's entry into eurozone is concerned, it should be conditioned by strong and sustainable integration in the European Union as well as by strengthening of foundations of Polish economy. It is necessary to implement structural reforms to foster further convergence which will reduce 'accession shock' (especially credit boom). Any risks should also be restrained by tight macroprudential supervision. In any case, structural reforms in Poland would be beneficial regardless of the intention of adoption of EURO as they would facilitate long-term economic growth. The most important changes to carry through are: strengthening of innovativeness and structural competitiveness, reducing of dualism in the labour market and maintaining its stability, improving job mobility, developing the market

[30] *Ekonomiczne wyzwania integracji Polski ze strefą euro*, NBP, 2014.

[31] For further explanation check: P. Szpunar, *Czy Polska powinna przystąpić do unii bankowej*?, Bank No 1 (262), 2015.

of flats for rent, increasing efficiency of products market and assuring the so called ‘fiscal space’.

A vital necessary condition for Polish accession into the eurozone is achieving and maintaining its financial stability. The reforms conducted so far indeed reinforced the stability in Europe and it is expected that the Banking Union will achieve its goals, however in a slightly different way than was previously intended. Although banking structures are still crisis-prone but really serious crises do not happen so frequently. It gives the newly created Banking Union a certain amount of room at the start. Regulatory requirements (liquidity and capital) have been reinforced and MREL is going to provide banks with further resistance (at the same time, however, MREL will make the banking system much less attractive than it was before the crisis). The safety net of finances has been strengthened, institutions of macroprudential supervision have been created on European, national and Banking Union level. Problems of big banks however may not be solved by means of *resolution*. Even if the regulatory reforms are successfully carried through and bridge financing is activated (for example from ESM resources), the politically motivated will to save the troubled bank may prevail. It is understandable because the *resolution* process in itself may entail serious negative implications for macroeconomic stability. Then the only rescue that remains is the *bail-out* option although this solution can pose a moral hazard. The markets still take for granted that big banks enjoy *implicit* government guarantees as market cost of their financing is lower. So, just out of necessity, *bail-out* is an acceptable second best solution which additionally is eligible for extra support from ESM.

In the long perspective, it is possible to strengthen the fiscal integration of the eurozone. The common European budget will not be created any time soon, however some hybrid semi-budget establishments may take up selected budgetary functions typical for unitary states[32]. A small ‘insurance’ budget where expenditure on individual states would be equal, as a rule, to their contributions would be a good idea with the money going where necessary on emergency basis in crisis conditions. The money would cover the costs of restructuring and liquidation of banks.

[32] On federal functions of fiscal policy see: *Ekonomiczne wyzwania integracji Polski ze strefą euro*, NBP, 2014.

The need for further fiscal integration of the eurozone is an issue frequently heard in public discussion[33]. The so called *Five Presidents' Report*[34] evidently points to the need to deepen the existing framework of cooperation within fiscal coordination and to create the European Financial Board, an institution for impartial assessment of fiscal policies and coordination of activities of national fiscal councils which must be established in accordance with the requirements of the Council of Europe's directive[35]. The authors of the Report even claim that maintaining fiscal discipline and possibility to use fiscal tools in order to manage asymmetric shocks requires further and deeper coordination than such which is only based on regulations. They argue that each mature monetary union should dispose of a stabilizing mechanism which would absorb shocks difficult to eliminate on national level. The authors do not define the final shape of the fiscal union as, in their opinion, it may take different forms. They only offer some guidelines for construing the fiscal union. According to these guidelines permanent one-way transfers must be forbidden and the transfers should not alleviate structural weaknesses in particular jurisdictions.

Apart from the hard to overcome political difficulties, the above rule seems to be unrealistic and the construction of the budget extremely painful because transfers are the essence of every budget. The direction of transfers would have to take into account differences in economic potential of countries, so it would be constant at least over the medium term. The next rule that budget should also prevent crisis and strengthen the immunity of the economy of the eurozone and its Member States but shouldn't be a crisis management tool (as this role is reserved for ESM), raises even more doubts. Such dualism however would impair resistance to crisis. If the eurozone in order to fortify its stability is to establish state-like institutions, then the common budget should perform both functions, and ESM may be treated as an additional instrument. The last resort and guarantor of the deposit is always the state although, as a rule, first the private deposit protecting funds from resolution must be used, then the ESM funds.

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[33] *Completing the Euro. A road map towards fiscal union in Europe*, Report of the "Tommaso Padoa-Schioppa Group". Notre Europe, 2012.

[34] *Completing Europe's Economic and Monetary Union*, Report by Jean-Claude Juncker, the European Commission, 2015.

[35] Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States.

ESM is a mere substitute of a budget, its resources may be used for aid purposes but are, by nature, limited. In this context it is worth mentioning that some economists[36] criticize the idea of creating common fiscal policy in the eurozone pointing to the fact that in the USA the role of transfers from the central budget in stabilizing economic situation of individual states is seriously limited. It seems that a better idea would be completing the creation of a solid banking union with a kind of 'insurance budget' as a potentially effective stabilizing instrument. Even a small budget of insurance for the financial system would considerably contribute to further fortification of financial stability in the eurozone. In times of global recession gigantic budget transfers in the USA were only linked to intervention on the financial market and to the rescue of banks. The eurozone 'insurance' budget will at the same time satisfy one of the fundamental conditions of the *Five Presidents' Report* as it would rule out one-way transfers. The budget could be used by countries up to the limit equal to their contributions and in times of crisis the funds could cover the costs firstly of restructuring and nationalization and then, payment of guaranteed deposits.

Conclusions

Establishment of the Banking Union, though in a form slightly different than originally planned, should considerably strengthen the financial stability in the euro area. Once it is completed it must be constantly perfected and updated for example by means of allowing to finance *resolution* process from ESM resources. The fiscal regulations although tighter still do not guarantee fiscal discipline in individual states. The Fiscal Union, on the other hand, seems to be an unrealistic endeavour at least in short term and medium period. Thus, there will be no universal shock absorbing instrument and individual states have to find ways to protect themselves. It can be achieved by construction of fiscal buffers, implementation of structural solutions which would minimize the shocks as well as ECB intervention on the debt market. Shocks from financial system should be watered down by the Banking Union instruments and ESM. Should the crisis in Greece be successfully resolved the eurozone will be safer. If, additionally, advanced tool of fiscal union are introduced (especially the 'insurance' budget) then the

[36] D. Gros, *False promise of a eurozone budget*, European Voice, http://www.politico.eu/article/false-promise-of-a-eurozone-budget/ (2015).

risks for Polish accession into the eurozone would be considerably reduced and it would also bring closer the fulfillment of one of the two basic preconditions of the accession.

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